CZAR RESOURCES LTD.

1986

ANNUAL REPORT

CZAR RESOURCES LTD.
and Subsidiary Companies

Abbreviations

Throughout this report standard oil and gas abbreviations have been used. Their explanation is as follows:

BBLS	Barrels
MSTB	Thousand Stock Tank Barrels
BOPD	Barrels of Oil Per Day
MMCF	Million Cubic Feet
MMCF/D	Million Cubic Feet Per Day
BCF	Billion Cubic Feet

Annual Meeting

The Annual Meeting of Shareholders of Czar Resources Ld. will be held on April 14, 1987 at 3:00 p.m. in the Lakeview Room of the Westin Hotel, Fourth Avenue and Third Street S.W., Calgary, Alberta.

PLEASE NOTE:

If you are a registered shareholder of Czar Resources Ltd., please direct any queries regarding changes of address, loss of certificates, etc. to our transfer agent, The Canada Trust Company, at their Calgary office.

If you are not registered with the transfer agent and receive material from the Company directly, please send any changes of address to Czar Resources Ltd. in Calgary.

CHANGE OF YEAR END

Czar has changed it's year end to December 31.

The first quarterly report for 1987 will reflect the results of operations to March 31, 1987 and will be published in May, 1987.

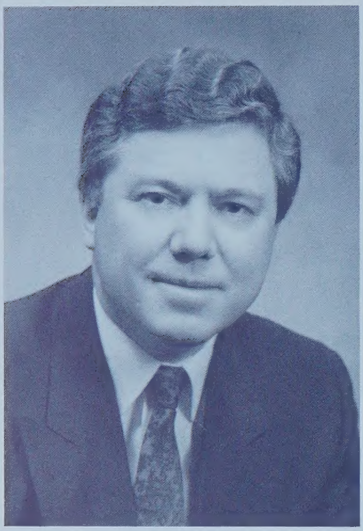
Highlights

FINANCIAL	1986	1985
GROSS REVENUE		
Canada	**$14,288,728**	$13,547,085
United States	**788,686**	1,683,511
Total	**$15,077,414**	$15,230,596
Cash flow from operations	**$ 3,143,954**	$ 5,056,629
Cash flow per share	**$ 0.27**	$ 0.43
Net earnings	**$ 308,635**	$ 3,111,746
Net earnings per share	**$ 0.03**	$ 0.27
Capital expenditures	**$ 5,204,571**	$ 7,005,770
Total assets	**$41,198,749**	$40,683,257
Common shares outstanding	**11,942,486**	11,651,886

OPERATING		
Production (before royalties)		
Crude oil and natural gas liquids (BBLS)	**201,665**	187,364
Average daily production (BOPD)	**552**	513
Natural gas (BCF)	**7.6**	5.8
Average daily production (MMCF/D)	**20.9**	15.9
Drilling Activity		
Gas completions	**17**	10
Oil completions	**2**	5
Dry and abandoned	**3**	5
Total Wells	**22**	20
Undeveloped Land Holdings		
Net Acres		
Alberta	**56,588**	57,993
British Columbia	**108,896**	122,008
Total net acres	**165,484**	180,001

	OIL (MSTB)	GAS (BCF)
RESERVES, before royalties		
Proved and probable — Canada	**957.0**	217.6

To The Shareholders



On behalf of the Board of Directors, I am pleased to report that during 1986 the Company made major progress in its long term refinancing efforts and has now achieved a position which should result in future stability. In addition, the Company reported satisfactory operating results despite the decline of oil and gas prices throughout the year.

Since the financial debacle of 1981 the Company's business plan has been to recover from its over-leveraged position by:

- controlling costs and restricting investment levels,
- expanding direct gas sales,
- placing shut-in gas properties on stream and,
- reducing financing charges through a bank restructuring involving the issue of preferred shares.

The foregoing remedial measures had a significant impact on the Company's financial position from 1982 to 1986, resulting in the following major improvements:

	1982	**1986**
	($ millions)	
Debt service costs	10.8	**5.5**
Overhead	4.9	**1.8**
Cash flow before financing charges	4.8	**8.6**
Cash flow	(6.0)	**3.1**

Furthermore, during this period the Company's gas marketing expertise and financial revival markedly improved the Company's business image.

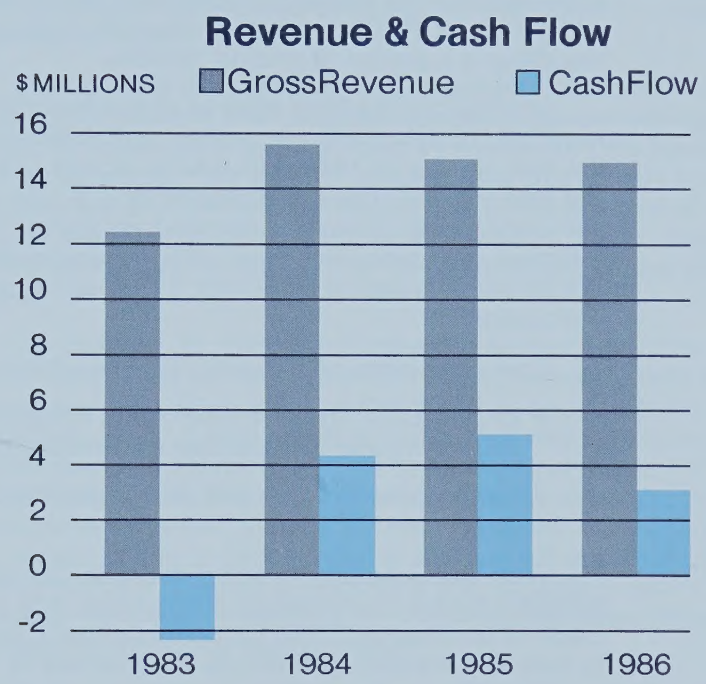
However, despite considerable progress being made, it became apparent with the onset of the 1986 oil price collapse that the Company would experience long-term difficulty with the level of debt it was carrying. An analysis of the underlying reasons for the decline in oil prices also convinced management that a strong likelihood existed that oil would remain below U.S. $20 per barrel for a lengthy period and that such an event would place Czar in a solely production company mode, at best.

Thus, during 1986 the Company reviewed various financing alternatives with its principal creditor, the Toronto Dominion Bank, and just prior to year end reached an agreement to issue, to the Bank, approximately 13.6 million shares in exchange for $30 million of debt. The agreement, which is subject to regulatory and shareholder approval, will reduce the Company's total liabilities to the lowest level since 1981.

While the refinancing was the Company's most important achievement during 1986, other highlights were:

Financial

- Czar's total revenues closely matched those of 1985 despite substantial drops in oil and gas prices
- Both cash flow and earnings declined due to non-recurring charges, and earnings also declined due to a higher depletion provision



Natural Gas Marketing

- The Company expanded its contract base and delivered record volumes of gas to industrial users

Flow Through Share Issues

- Czar began an exploration program to incur expenditures amounting to $2.9 million in consideration for the issue of 1.2 million common shares
- Subsequent to year end Czar entered into a second agreement to issue up to $3 million of common shares at $2.11 per share, in consideration for incurring exploration expenses on the Company's properties in 1987

Sale of United States Operations

- On December 31, 1986, the Company sold its two United States subsidiary companies for two notes totalling $2.8 million
- Immediately prior to the sale, one U.S. subsidiary declared a dividend to Czar of approximately $2.5 million, which cash will be available to the Company in 1987

Outlook

The Company anticipates that 1987 will be more favourable to the energy business than 1986, if in no other respect than the shocks of last year can be incorporated into operating plans.

The Organization of Petroleum Exporting Countries' objective of regaining market share and casting a cloud of investment uncertainty on the non-OPEC energy business has clearly been achieved, but it is hoped that gradually falling non-OPEC production will balance OPEC's desired production level before too long, resulting in a period of pricing stability.

In addition, the long decline of the lower 48 United States gas reserves, coupled with record low gas reserves replacement since the first quarter of 1986, will lead to tighter U.S. gas supplies towards the end of 1987. The deterioration of U.S. gas reserves has been camouflaged by lower gas demand resulting from high gas prices and interfuel switching. However, with the downward trend of gas prices and increasing oil prices, a pick-up in gas demand is anticipated.

Czar's business plan during 1987 will be to continue its efforts to:

- capitalize on the Company's gas marketing expertise and reserves base by selective expansion in these areas, while
- futher consolidating and improving the Company's financial strength.

With the Company's capital demands for ongoing exploration satisfied by the flow-through share issue, and production facility costs to be financed from future cash flow, Czar now has the flexibility to look at a number of financial alternatives to improve its overall position. These may include a sale of equity, company acquisitions, sale of properties, or the sale and lease back of equipment, and will be reviewed by the management as the year progresses.

Now that the Company has survived one of the worst years in the history of the Canadian energy business, I look forward to continued progress in the new year. I would like also to extend to the staff of the Company the thanks of the Board of Directors and the stockholders for their hard work and accomplishments during the year.

On behalf of the Board,

R.W. Lamond

January 20, 1987

Financial

Despite the abrupt drop in energy prices throughout 1986, the Company's increased sales of gas and natural gas liquids resulted in a satisfactory financial performance.

Total revenues were $15.1 million, closely comparable with those of the prior year. Cash flow was reduced to $3.1 million from $5.1 million in 1985 partly as a result of a number of non-recurring interest and other charges which totalled $1.2 million. Due to higher production volumes, depletion charges were substantially increased and earnings were reduced to $308,000 from the $3.1 million reported in 1985.

During 1986 the Company expended $3.3 million on fixed asset additions consisting of $1.3 million for development drilling, $1 million for production facilities, and $1 million for new land acquisitions and lease rentals. The level of reinvestment was closely monitored and was virtually completely funded by Czar's cash flow of $3.1 million. To year end, Czar expended an additional $834,000 on exploratory drilling which was funded by the 1986 placement of flow-through shares.

On October 30, 1986 the Company's banker agreed to restructure Czar's obligations by the conversion of $30 million of debt to common shares. Bank loans of $12.5 million and preferred shares of a subsidiary of $17.5 million will be converted into approximately 13.6 million common shares giving the bank 49.9% of the common shares outstanding, taking into account arrangements to issue common shares which were in place at October 30, 1986. Czar anticipates that the annual saving in debt servicing charges will approximate $2.4 million per year. Though shareholder and regulatory approval is still pending, the effect of the debt restructuring has been shown in the Company's pro-forma balance sheet.

On November 10, 1986 the Company entered into a second agreement with Nim and Company, Limited Partnership — 1987 to issue up to 1.4 million common shares at $2.11 per share in respect of exploration expenditures to be incurred on behalf of the investors in 1987.

On December 31, 1986 the Company sold its two United States subsidiaries for $2.8 million in notes which will partly be paid out of production revenues. One of the subsidiaries declared a dividend to the Company of approximately $2.5 million prior to its sale. This cash will be available to Czar in 1987.

While the foregoing transactions will still leave the Company with net liabilities of approximately $43 million, this level of indebtedness, when contrasted with its large oil and gas asset base, at last places the Company in a position from which a full financial recovery can be achieved.

Production

As a result of the Company's direct marketing efforts, gas production levels were significantly higher than those of the prior year. Canadian gas production averaged 20.5 MMCF/D, a 33% increase from the 15.4 MMCF/D rate in 1985.

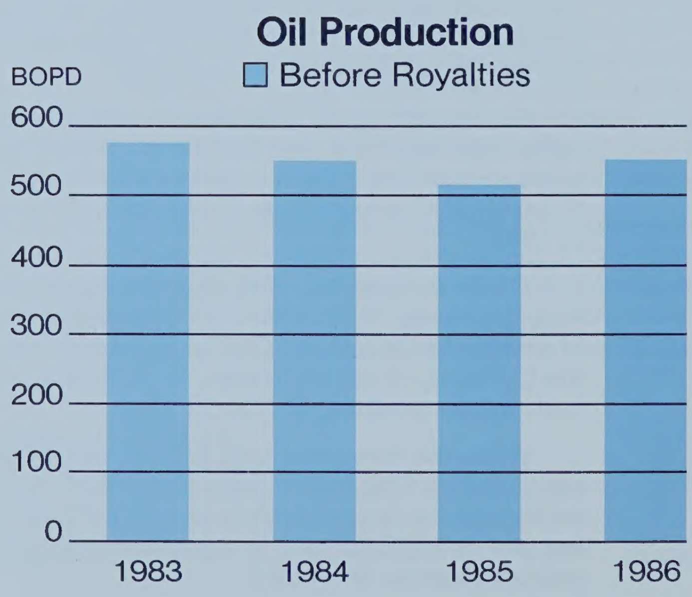
Canadian oil and natural gas liquids production increased from 396 BOPD in 1985 to 461 BOPD, as a result of increased liquids produced in association with higher natural gas production.

Throughout 1986 oil and gas prices steadily declined with the result that the higher volumes virtually offset lower prices and maintained overall production revenues at the 1985 level.

The Company anticipates that both oil and gas prices will remain close to current levels throughout 1987.

Average Product Prices

	1985	**1986**
Canadian ($CDN)		
Oil — $/BBL	36.26	**20.23**
Gas — $/MCF	2.07	**1.79**



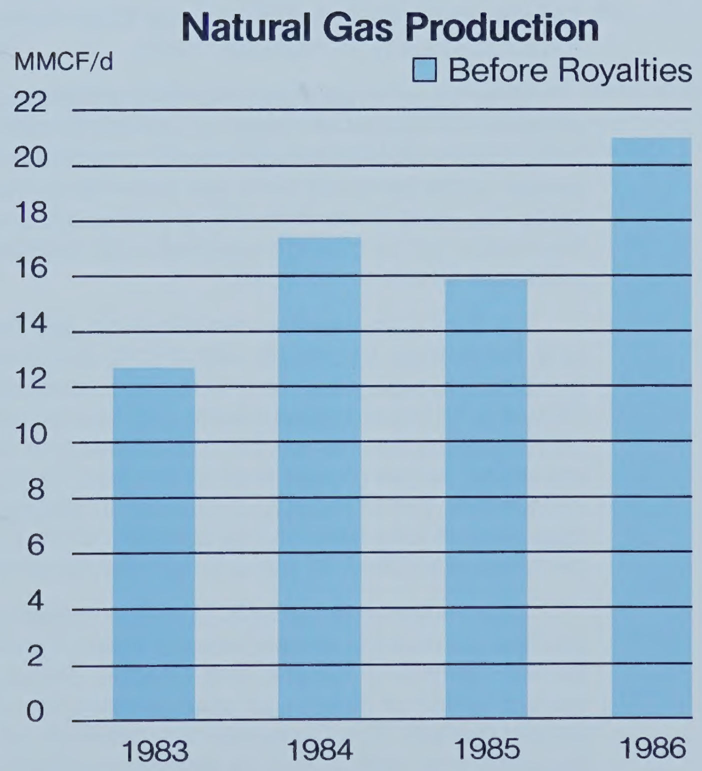
Reserves

Due to pricing uncertainties during the year, a reserve evaluation by an independent petroleum consultant was not commissioned for 1986.

However, an in-house evaluation by Czar's engineering staff estimated year end reserves, before royalties, to be as follows:

Natural Gas (BCF)	217.6
Crude Oil and Natural gas liquids (MSTB)	957.0

The Company's primary exploration objective has been to replace its gas production on an annual basis and during 1986 new gas reserve additions totalled 13.6 BCF, comparing favourably with production of 7.6 BCF.



Natural Gas Marketing

During 1986 the Company expanded its direct sales efforts and was successful in increasing the number of its industrial customers and the volume of gas delivered. A summary of gas sales from Czar operated wells shows the success of this marketing effort:

Direct Gas Sales (BCF)*	1984	1985	**1986**
Alberta — Industrial	9.7	7.8	**8.7**
B.C. — Industrial	1.5	2.0	**8.0**
U.S. — Export	—	2.3	**1.1**
TOTAL	11.2	12.1	**17.8**

*Includes Czar & Partners

The direct marketing of natural gas, especially under conditions of rapid fuel switching and the deregulatory chaos which prevailed during 1986, required a constant alertness to changing marketing conditions.

The Company's major objectives during the early part of 1986 were to retain its Canadian markets and expand its sales to industrial buyers in the United States. Czar was successful in commencing deliveries to the Weyerhaeuser and Mobil facilities in the U.S. Pacific Northwest but these companies switched from gas to fuel oil as oil prices collapsed and Czar's sales to these customers terminated early in February 1986.

Czar commenced a series of applications to lower its gas price to competitive levels and after a protracted effort was successful in obtaining National Energy Board approval to reduce the adjacent border price for short term gas exports at Huntingdon, B.C. While sales resumed to certain U.S. purchasers, the publicity surrounding the border price change enabled U.S. competitors to quickly undercut Czar's price again.

Further complicating the situation was the reluctance of certain U.S. trunk lines to comply with FERC Order 436 requiring nondiscriminatory transportation of natural gas for third parties. Faced with these impediments and having endured the problems of attempting to change the export price to realistic levels, while still obtaining prices higher than those paid by our Canadian customers, the Company chose not to subject itself to further aggravation and temporarily suspended its U.S. sales efforts pending resolution of the pricing and pipeline problems.

This switch in emphasis in mid-summer proved to be successful as Czar completed several new Canadian direct sales contracts in British Columbia, Alberta and Ontario, and at this date has reached record levels of direct gas sales despite its withdrawal from the export market. The Company has retained all of its industrial contacts and, with a well developed marketing expertise ranging from British Columbia to Quebec in Canada and covering the western United States, is in a position to take advantage of an open gas marketing environment, when it develops.

Exploration and Development

Czar participated in 22 wells during 1986, resulting in 17 gas wells, two oil wells, and three dry holes. The Company continued to concentrate its exploration efforts in central Alberta, where the combination of reasonable reserves per well coupled with shallow, inexpensive drilling, resulted in satisfactory exploration economics.

With Czar's access during 1986 to exploration funds from the flow-through share issue, the Company was able to participate for much larger interests in wells than it ever has to date. The success and early connection to market of the following key wells will help rapidly boost Czar's gas sales during 1987.

- Medicine River 13-28 — Czar has a 62% interest in the well which stabilized at 9.9 million cubic feet of gas per day, from the Pekisko zone, during production tests.
- Mikwan 13-2 — The Company has a 92% interest. The well flowed 2.2 million cubic feet of gas per day on completion.
- Gadsby 11-26 — Czar has a 69% interest in this dual zone gas well which flowed 2.7 million cubic feet of gas per day from a Belly River channel sand.
- Stettler South 10-26 — The Company has a 78% interest. Gas was flowed at up to 1.2 million cubic feet of gas per day on drill stem test.

Czar anticipates that during 1987 the bulk of its new exploration funding will again be expended in central Alberta, although selected prospects in other areas will also be reviewed.

Auditors' Report

To the Shareholders of
Czar Resources Ltd.

We have examined the consolidated balance sheet of Czar Resources Ltd. as at October 31, 1986 and the consolidated statements of earnings, deficit and source and use of cash for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at October 31, 1986 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Canada
January 4, 1987

Thorne Ernst & Whinney
Chartered Accountants

Compilation Report

To the Directors of
Czar Resources Ltd.

We have reviewed, as to compilation only, the accompanying pro-forma consolidated balance sheet of Czar Resources Ltd. as at October 31, 1986, which has been prepared for inclusion in the consolidated financial statements of Czar Resources Ltd. as at October 31, 1986. In our opinion, the pro-forma consolidated balance sheet has been properly compiled to give effect to the proposed transaction and the assumptions described in Note 2 thereto.

Calgary, Canada
January 4, 1986

Thorne Ernst & Whinney
Chartered Accountants

CZAR RESOURCES LTD.
and Subsidiary Companies

Consolidated Balance Sheet

As at October 31, 1986

ASSETS	1986 Pro-forma (note 2)	1986	1985
Current Assets			
Cash	$ 2,564,025	$ 2,564,025	$ 2,382,387
Accounts receivable	5,036,364	5,036,364	7,111,831
Inventory of supplies, at lower of cost and net realizable value	317,302	317,302	277,233
	7,917,691	7,917,691	9,771,451
Fixed Assets (note 4)			
Petroleum and natural gas leases and rights including exploration, development and equipment thereon, at cost	41,331,435	41,331,435	36,277,984
Other	1,461,501	1,461,501	1,356,943
	42,792,936	41,792,936	37,634,927
Accumulated depletion and depreciation	9,511,878	9,511,878	6,723,121
	33,281,058	33,281,058	30,911,806
	$ 41,198,749	$ 41,198,749	$ 40,683,257
LIABILITIES			
Current Liabilities			
Accounts payable and accrued liabilities	$ 13,973,970	$ 13,973,970	$ 14,620,013
Long-term Debt (note 5)	5,000,000	17,500,000	17,500,000
Preferred shares of a subsidiary company (notes 2 and 6)	37,500,000	55,000,000	55,000,000
CAPITAL STOCK AND DEFICIT			
Capital Stock (note 7)	43,769,285	13,769,285	12,916,385
Deficit (note 7)	(59,044,506)	(59,044,506)	(59,353,141)
	(15,275,221)	(45,275,221)	(46,436,756)
	$ 41,198,749	$ 41,198,749	$ 40,683,257

Approved by the Board:

, Director

, Director

CZAR RESOURCES LTD.
and Subsidiary Companies

Consolidated Statement of Earnings

As at October 31, 1986

	1986	1985
[illegible]		
Production	**$ 14,220,713**	$ 14,937,793
Less: Provincial royalties	**1,664,393**	1,978,393
Freehold royalties	**919,054**	849,486
Petroleum and gas revenue tax	**—**	574,490
Alberta royalty tax credit	**(673,245)**	(608,575)
	1,910,202	2,793,794
Net production revenue	**12,310,511**	12,143,999
Principal and interest from property dispositions	**2,081,819**	2,186,505
Other	**685,084**	900,092
	15,077,414	15,230,596
[illegible]		
Production	**3,488,762**	3,393,825
General and administrative	**1,776,270**	1,312,688
Interest on long-term debt	**1,216,012**	1,265,207
Interest — other	**425,323**	—
Other	**750,000**	150,000
Depletion and depreciation	**2,835,319**	1,944,883
	10,491,686	8,066,603
[illegible]	**4,585,728**	7,163,993
Dividends on preferred shares of a subsidiary company (note 6)	**4,277,093**	4,052,247
[illegible]	**$ 308,635**	$ 3,111,746
[illegible] (note 10)		
Net earnings	**$0.03**	$0.27
Cash flow	**$0.27**	$0.43

Consolidated Statement of Deficit

Year Ended October 31, 1986

	1986	1985
Beginning of year	$(59,353,141)	$(62,464,887)
Net earnings	308,635	3,111,746
End of year (note 7)	$(59,044,506)	$(59,353,141)

Consolidated Statement of Source and Use of Cash

Year Ended October 31, 1986

	1986	1985
Operating Activities		
Net earnings	$ 308,635	$ 3,111,746
Depletion and depreciation	2,835,319	1,944,883
Working capital provided by operations	3,143,954	5,056,629
Net change in non-cash working capital items	1,659,355	1,870,325
	4,803,309	6,926,954
Investing Activities		
Additions to fixed assets		
Current operations	(3,254,319)	(7,005,770)
Partnership equalization payment	(1,116,252)	—
Flow-through share arrangement	(834,000)	—
Financing Activities		
Increase in bank loan	—	2,260,000
Discharge of limited partnership redemption obligations	(270,000)	(540,000)
Common shares issued and to be issued pursuant to flow-through share arrangement	834,000	—
Common shares issued for cash	18,900	34,999
Increase in cash	181,638	1,676,183
Cash at beginning of year	2,382,387	706,204
Cash at end of year	$ 2,564,025	$ 2,382,387

CZAR RESOURCES LTD.
and Subsidiary Companies

Notes to Consolidated Financial Statements

Year Ended October 31, 1986

1. Accounting Policies (See Note 3)

The consolidated financial statements include the accounts of Czar Resources Ltd. and its subsidiary companies, which are wholly-owned.

The accounts of the foreign subsidiary are translated to Canadian dollars on the following basis:

(i) monetary assets and monetary liabilities at the rate of exchange in effect as at the balance sheet date.

(ii) non-monetary assets and non-monetary liabilities at the rates of exchange in effect at the dates on which the assets were acquired or the liabilities incurred.

(iii) revenue and expenses (excluding depreciation and depletion which are translated at the same rate as the related assets) at the average rate of exchange for the year.

(iv) gains or losses resulting from such translations are charged or credited to earnings.

(i) The Company follows the full cost method of accounting for petroleum and natural gas operations whereby all costs of exploring for and developing petroleum and natural gas reserves are capitalized by cost centre. A separate cost centre is established for each country in which the Company operates, presently Canada and the United States. Costs include land acquisition costs, geological and geophysical expenditures, carrying charges on non-producing property, costs of drilling both productive and non-productive wells, related overhead expenditures and capitalized interest related to major development projects. Costs of acquiring and evaluating unproved properties and certain major development projects are excluded from the depletion calculation until it is determined whether or not proved reserves are attributable to those properties or major development projects are complete or impairment occurs. Costs are depleted by cost centre using the composite unit of production method based upon estimated proved reserves after royalties. Crude oil reserves are converted to equivalent units of natural gas based on the relative energy content of each product.

(ii) Aggregate net book value in each cost centre which can be carried forward for amortization against revenues of future periods (the "cost ceiling") are limited to an amount equal to the estimated future net revenues from proved reserves, based on current prices and costs, plus the lower of cost or estimated fair value of unproved properties and major development projects. The aggregate estimated future net revenues and value of unproved properties and major development projects for all cost centres is further reduced by estimated future general and administrative expenses, financing costs and income taxes.

(iii) Under certain drilling programs, a significant portion of the consideration for the sale of properties by the Company is receivable in installments. Principal and interest payments, in the aggregate, may not exceed a fixed percentage of net revenue from the wells drilled. Unpaid principal installments total $41,893,251 at October 31, 1986 (1985 — $43,441,242). Such principal and interest payments are recorded as and when received.

(iv) All of the Company's exploration and development activities related to petroleum and natural gas are conducted with others; the Company records only its proportionate interest in such activities.

b. Depreciation

Depreciation of petroleum and natural gas production equipment and related facilities is provided on the composite unit of production method based on estimated proved reserves of each cost centre. Depreciation of other equipment is provided on a straight-line basis at rates which are estimated to amortize the cost of the assets over their useful lives.

2. Financial Restructuring

The Company and its banker have agreed, effective October 31, 1986, to pursue a restructuring of the Company's debt. The restructuring is conditional upon receiving shareholder and regulatory approvals and negotiation of definitive terms between the Company and its banker.

The Company will issue to its banker common shares on the conversion of $12.5 million in bank loans and $17.5 million in preferred shares of a subsidiary company. The Company's banker will then own 49.9% of the outstanding common shares, taking into account arrangements to issue common shares which existed at October 31, 1986.

The Company's remaining debt will be reduced in the first two years by an annual dedication of cash flow, amounting to 20% of the first $2 million of cash flow and 60% of any excess over $2 million, with an minimum annual repayment of $400,000. Subsequent repayment terms are being negotiated. The remaining preferred shares of a subsidiary company will be retractable on demand.

The pro-forma balance sheet has been prepared based upon this agreement before giving effect to the costs of restructuring.

3. Future Operations

These financial statements have been prepared on the basis that the Company will continue to operate and meet its obligations throughout the twelve months subsequent to October 31, 1986.

If the financial restructuring described in note 2 is not concluded, the Company's ability to meet its obligations is dependent upon the continued support of the Company's banker.

Fixed Assets

Fixed assets include overhead costs which are incurred in the exploration and development of oil and gas properties, amounting to $472,155 in 1986 (1985 — $610,130). In 1986 and 1985 the Company has not capitalized any interest expense or excluded costs from depletable costs pursuant to its accounting policies.

If the refinancing described in note 2 is not completed, a write-off of the petroleum and natural gas assets would be required at October 31, 1986 in accordance with the determination of the cost ceiling using the Guideline of the Canadian Institute of Chartered Accountants.

Long-Term Debt

	1986 Pro-forma	**1986**	1985
	(note 2)		
Bank loan	**$5,000,000**	**$15,000,000**	$15,000,000
Bank loan, non-interest bearing	**—**	**2,500,000**	2,500,000
	$5,000,000	**$17,500,000**	$17,500,000

The Company has a revolving line of credit of $15 million. The interest rate on $8 million of the loan is fixed at 10.98% to November 8, 1988; thereafter it will fluctuate at prime plus ¼%. The remaining $7 million bears interest at prime plus ¼%. The non-interest bearing loan of $2.5 million relates to accrued but unpaid interest on the previous bank loans. The bank loans are evidenced by notes payable on demand and are secured by the floating charge debenture and other security described in note 6.

The bank loans, advanced under a credit facility which is reviewed annually, have no specific terms of payment. The loans are to be paid out of future oil and gas production revenues.

Preferred Shares of a Subsidiary Company

In 1984, the Company caused a wholly-owned subsidiary to issue to the Company's banker $55,000,000 of cumulative, redeemable, non-voting first preferred shares. The proceeds of the issue were borrowed by the Company from its subsidiary and were used to reduce its long-term bank loan. The Company is required to fund quarterly dividends on the preferred shares at a rate of approximately 7.35% to February 15,1988, and thereafter at one half bank prime for the quarter plus 1%.

The Company has the obligation to fund the redemption of the preferred shares by February 28 each year in an amount defined as the Company's "Excess Cash Flow", less $200,000, as determined for the immediately preceding fiscal year. No redemption of the preferred shares is required on February 28, 1987 because "Excess Cash Flow" in respect of the Company's fiscal year ended October 31, 1986 is insufficient to require funding of such redemption. All of the preferred shares must be redeemed on or before March 15, 1989 from additional bank borrowings or alternative financing.

In the five year term of the preferred shares, the Bank is to receive warrants to purchase 1,162,855 common shares of the Company. As at October 31, 1986 the Bank has received 930,284 warrants and will receive 232,571 warrants on October 31, 1987. The warrants are exercisable for a period of five years, at the closing market price of the common shares at the dates on which the warrants are issued.

The bank has the right to sell the preferred shares to the Company at any time. In the event the Company is unable to consummate the purchase, the bank may assert its rights under a floating charge debenture on all the assets of the Company and assignments of accounts receivable and certain petroleum and natural gas properties and revenue interests therein. The Company has agreed with the bank that it will not encumber any of its assets or dispose of any of its petroleum and natural gas properties, other than to its joint venture participants in the normal course of business, without, in each case, the consent of the bank.

7. Capitalized Stock and Deficit

(a) Authorized Capital Stock

10,000,000	First preference shares issuable in series
10,000,000	Second preference shares issuable in series
30,000,000	Common shares

(b) Issued and to be Issued Capital Stock

	Number of Shares	Consideration
Common Shares outstanding at October 31, 1985	11,651,886	$12,916,385
Issued and to be issued pursuant to flow-through share arrangement	278,000	834,000
Issued for cash on exercise of stock options	12,600	18,900
Common Shares issued and to be issued at October 31, 1986	11,942,486	$13,769,285

(c) Common Share Options

At October 31, 1986 directors, officers and employees held options to purchase 849,100 common shares of the Company at prices ranging from $1.50 to $1.65 per share exercisable from time to time to July 1989.

(d) Common Share Purchase Warrants

At October 31 1986, 930,284 common share purchase warrants were outstanding entitling the Company's banker to purchase common shares as follows:

Number of Shares	Price	Expiry Date
232,571	1.86	May 15, 1989
232,571	1.60	October 31, 1989
232,571	2.16	October 31, 1990
232,571	1.71	October 31, 1991

(e) Deficit

At the special general meeting of the Shareholders held on April 18, 1984 the shareholders authorized the reduction of the capital reserve fund by $145,500 which was applied against the deficit and the reduction of the common share capital by $46,767,254, being the amount of the deficit as at October 31, 1983.

Income Taxes

At October 31, 1986, the Company had $57,894,000 of tax costs in excess of net book value available to reduce future years' income for tax purposes, the tax benefit of which has not been reflected in the financial statements.

There is no provision for deferred taxes in 1986 and 1985 as there are sufficient costs for accounting purposes available to offset future earnings for a number of years. A summary of the items which reduce taxable income for accounting purposes is as follows:

	1986	1985
Net earnings	**$ 308,365**	$ 3,111,746
Increased (decrease) in taxable income resulting from:		
Non-deductible preferred share dividends	**4,277,093**	4,052,247
Non-deductible provincial royalties and lease rentals	**1,839,220**	2,103,486
Alberta royalty tax credits	**(673,245)**	(608,575)
Non-deductible petroleum and gas revenue tax	**—**	574,490
Resource allowance	**(1,853,920)**	(2,156,851)
Earned depletion allowance	**(1,338,665)**	(1,025,821)
Application of prior years' losses	**(2,563,548)**	(6,045,709)
Other	**4,700**	(5,013)
Taxable Income for Accounting Purposes	**$ 0**	$ 0

8 Segmented Information

The Company has a single line of business, which is the exploration for and the development and production of petroleum and natural gas. Information about the Company's operations by geographic segment is as follows:

	Year Ended October 31, 1986		
	Canada	**U.S.A.**	**Total**
		(note 11(c))	
Identifiable assets	**$36,082,207**	**$5,116,542**	**$41,198,749**
Net production revenue	**$11,521,825**	**$ 788,686**	**$12,310,511**
Principal and interest from property dispositions	**2,081,819**	—	**2,081,819**
Other	**685,084**	—	**685,084**
	14,288,728	**788,686**	**15,077,414**
Less:			
Production expense	**3,284,265**	**204,497**	**3,488,762**
Depletion and depreciation	**2,835,319**	—	**2,835,319**
Operating profit	**8,169,144**	**584,189**	**8,753,333**
General and administrative costs	**2,295,327**	**225,275**	**2,520,602**
Capitalized general and administrative costs	**(472,155)**	—	**(472,155)**
Interest — other	**425,323**	—	**425,323**
Other	**750,000**	—	**750,000**
Bad debts (recovered)	—	**(272,177)**	**(272,177)**
Interest expense	**1,400,834**	**(184,822)**	**1,216,012**
	4,399,329	**(231,724)**	**4,167,605**
Earnings before preferred share dividends	**$ 3,769,815**	**$ 815,913**	**$ 4,585,728**

	Year Ended October 31, 1985		
	Canada	**U.S.A.**	**Total**
		(note 11(c))	
Identifiable assets	$35,651,994	$5,031,263	$40,683,257
Net production revenue	$10,460,488	$1,683,511	$12,143,999
Principal and interest from property dispositions	2,186,505	—	2,186,505
Other	900,092	—	900,092
	13,547,085	1,683,511	15,230,596
Less:			
Production expense	2,866,480	527,345	3,393,825
Depletion and depreciation	1,944,883	—	1,944,883
Operating profit	8,735,722	1,156,166	9,891,888
General and administrative costs	2,165,817	279,409	2,445,226
Other	150,000	—	150,000
Capitalized general and administrative costs	(610,130)	—	(610,130)
Bad debts (recovered)	—	(522,408)	(522,408)
Interest expense	1,407,785	(142,578)	1,265,207
	3,113,472	(385,577)	2,727,895
Earnings before preferred share dividends	$ 5,622,250	$1,541,743	$ 7,163,993

10. Net Earnings and Cash Flow Per Common Share

Net earnings and cash flow per common share are calculated using the average number of common shares outstanding during the year of 11,670,965. The calculation of cash flow per common share is based on "working capital provided by operations" as reflected in the Consolidated Statement of Source and Use of Cash.

If the financial restructuring described in note 2 is concluded, the pro-forma earnings per share would be $0.12 and the pro-forma cash flow per share would be $0.24.

11. Subsequent Events

(a) Subsequent to October 31, 1986, the Company executed a letter of intent with an investment company whereby the Company will issue common shares in respect of exploration expenditures incurred on behalf of the company's investors. The tax benefits associated with these expenditures will flow through to the investors. The Company may spend up to $3 million under this arrangement until expiry on December 31, 1987 and will issue shares at $2.11.

(b) Subsequent to October 31, 1986, the Company incurred exploration expenditures of $1,291,000 and issued 454,456 common shares pursuant to a flow-through share arrangement.

(c) On December 31, 1986, the Company sold both of its United States subsidiaries for two promissory notes totalling $2.8 million. Immediately prior to the sale, one of the subsidiaries declared a dividend of approximately $2.5 million to the Company. Payment on the notes is dependent on certain future events, and accordingly the receipt and gain will be recorded as and when received.

12. Contingent Liability

The Company is contingently liable in respect of alleged obligations to certain limited partnerships approximating $3 million. Management is of the opinion that the claims are without merit and counter claims are available to offset the liabilities, if any.

CZAR RESOURCES LTD.
and Subsidiary Companies

Board of Directors and Officers

Robert W. Lamond, Director
Chairman of the Board
& Chief Executive Officer
Calgary, Alberta

Bonita O. Rawlyck, Director
Senior Vice President, Finance
& Chief Financial Officer
Calgary, Alberta

Brian C. Bentz, Director
Vancouver, British Columbia

Charles A. Teare, Director
Calgary, Alberta

Allan R. Twa
Corporate Secretary
Calgary, Alberta

Key Personnel

P. Richard Ewacha
Engineering Manager

Sharon P. Runge
Land Manager

Herbert J. Visscher
Exploration Manager

Paul M. Boechler
Controller

Donald K. Clark
Engineering Superintendent
British Columbia

Philip W. Payzant
Engineering Superintendent
Alberta

Corporate Office

Suite 700, 425 - First Street S.W.
Calgary, Alberta
T2P 3L8
(403) 265-0270 Telex 03-826735

Field Office

P.O. Box 6718
Fort St. John
British Columbia
V1J 4J4
(604) 787-7718

Legal Counsel

Burnet, Duckworth & Palmer
425 - First Street S.W., 32 Fl.
Calgary, Alberta
T2P 3L8

Auditors

Thorne Ernst & Whinney
205 - 5 Avenue S.W, Ste. 1200
Calgary, Alberta
T2P 4B9

Registrar & Transfer Agent

The Canada Trust Company
505 Third Street S.W.
Calgary, Alberta
T2P 3E6

Wholly-Owned Subsidiary

Czar Financing Alberta Ltd.

Stock Listings

The Toronto Stock Exchange

The Alberta Stock Exchange

Trading Symbol — CZR

CZAR
RESOURCES LTD.

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CZAR RESOURCES LTD.
and Subsidiary Companies

GAS MARKETING

Gas production volumes sold to Czar's industrial customers increased significantly during the first half of 1986, mainly due to larger deliveries of natural gas to new purchasers in British Columbia.

	FIRST HALF 1986	FIRST HALF 1985
	BILLIONS OF CUBIC FEET*	
Alberta — Industrial	5.94	4.70
B.C. — Industrial	3.23	1.28
B.C. — Export	1.43	0.97
	10.60	6.95

*Includes Czar and partners.

Though falling fuel oil prices in the spring of 1986 resulted in some of Czar's United States customers switching from natural gas to fuel oil, the Company entered into sales agreements with several new U.S. industrial buyers to maintain export volumes. While the gas price yielded by these new sales in every case exceeded prices paid by Czar's Canadian industrial purchasers, the average price resulted in a border netback lower than the federally set minimum export price. Czar management felt that it was not violating either the letter or the spirit of the Federal-Provincial agreement setting adjacent border prices, which states that "the price of exported gas must not be less than the price charged to Canadians for similar service in the area or zone adjacent to the export point", and consequently Czar continued its export sales. However, to expedite a resolution of this policy matter due to limited progress in various applications and submissions, the Company took the unusual step of announcing that it was exporting gas at prices lower than the arbitrarily established border reference price which did not represent prevailing market conditions or the policy philosophy.

While Czar's sales were suspended by the National Energy Board during the month of June, further debate on this issue and subsequent policy announcements by the Province of British Columbia, confirmed Czar's pricing arguments and policy interpretation and the Company is confident that it will obtain National Energy Board approval imminently, establishing lower, market-sensitive gas prices for its export sales.

AR44

EXPLORATION

During the first half of the year, Czar participated in the drilling of eight wells, resulting in two oil wells, five gas wells and one dry hole.

Most significant was a well in the Medicine River area of central Alberta which penetrated 60 feet of Pekisko gas pay. The well, in which Czar has a 62% working interest flowed gas on completion at rates in excess of 7 MMCF/D. The well is expected to be placed on production by August of this year.

During the second half of 1986, the Company anticipates increasing its exploration efforts with the primary aim of expanding its central Alberta gas reserves. Czar's flow-through share funding combined with benefits from the recently announced Alberta government activity program will enable the Company to engage in one of the most active drilling programs it has undertaken in years.

OUTLOOK

While Czar anticipates an active year in the exploration and marketing areas, the business climate under which oil and gas companies are operating is the most severe in the last decade. Hence, the Company will continue to closely monitor its level of activity and expenditures to be able to react to any further adverse events.

On behalf of the Board,

R. W. Lamond
Chairman

June 24, 1986

CZAR RESOURCES LTD.
Suite 700, 425 First Street S.W.
Calgary, Alberta T2P 3L8

Printed in Canada

CZAR RESOURCES LTD.

INTERIM REPORT TO SHAREHOLDERS

6 MONTHS ENDED APRIL 30, 1986

CZAR RESOURCES LTD.
and Subsidiary Companies

JUL/6, 1986

TO THE SHAREHOLDERS

On behalf of the Board of Directors, I am pleased to report that for the six month period ended April 30, 1986, Czar's revenues, cash flow and earnings were at record levels and showed marked improvements from 1985, despite the period being one of steadily declining product prices.

FINANCIAL

Due to increased oil and gas production volumes, gross revenues for the period increased to $10 million, representing a 17% increase from the prior year. Net earnings, after dividends on preferred shares, increased to $3.4 million from the restated $2.9 million in 1985. Cash flow increased by 25% to $4.5 million or $0.39 per share.

The Company's prior change in accounting policy resulted in a restatement of 1985 financial results and increased earnings in the first half of that year by $972,000. Cash flow was unchanged.

Due to unstable industry conditions resulting from low product prices, the Company's reinvestment level during the period was severely restricted and totalled $1.8 million or 40% of cash flow. Fixed charge coverage for the period increased to 2.7:1 from 2.4:1 in 1985.

During the last quarter, the Company committed to a $1 million increase in the NIM flow-through share arrangement. This brings to $3 million the amount of exploration funding available to the Company to be expended during the balance of 1986.

PRODUCTION

Production volumes net to Czar before royalties, for the first six months were:

	FIRST HALF 1986		FIRST HALF 1985	
	BOPD	MMCF/D	BOPD	MMCF/D
Canada	550	26.1	337	19.3
United States	86	0.4	119	0.5
	636	26.5	456	19.8

The 35% increase in gas production was due mainly to the commencement of deliveries to new British Columbia industrial purchasers. Higher Canadian gas sales also resulted in increased volumes of natural gas liquids produced in association with the gas.

PRODUCT PRICES

	FIRST HALF 1986		FIRST HALF 1985	
	BBL	MCF	BBL	MCF
Canada ($CDN)	26.67	1.88	37.76	2.13
United States ($U.S.)	16.13	3.05	25.80	3.28

Both Canadian and United States oil and gas prices declined abruptly in the second quarter of the year. This resulted from OPEC price pressures caused by a determined effort to retain a reasonable oil market share and fierce North American gas price competition.

CZAR RESOURCES LTD.
CONSOLIDATED STATEMENT OF EARNINGS
SIX MONTHS ENDED APRIL 30, 1986
(Unaudited)

	1986	1985 (restated)
Revenue		
Production	$ 9,675,384	$ 8,708,222
Less: Provincial royalties	1,250,709	1,437,549
Freehold royalties	589,477	562,658
Petroleum and gas revenue tax	—	186,983
Alberta royalty tax credit	(400,121)	(321,202)
	1,440,065	1,865,988
Net production revenue	8,235,319	6,842,234
Principal and interest from property dispositions	1,386,524	1,436,775
Other	419,772	290,775
	10,041,615	8,569,784
Expenses		
Production	1,984,885	1,603,491
General and administrative	834,187	698,666
Interest on long-term debt	586,486	641,522
Depletion and depreciation	1,155,285	755,697
	4,560,843	3,699,376
Earnings Before Preferred Share Dividends	5,480,772	4,870,408
Dividends on preferred shares of a subsidiary company	2,097,958	1,982,367
Net Earnings	$ 3,382,814	$ 2,888,041
Per Common Share		
Net earnings	$ 0.29	$ 0.25
Cash Flow	$ 0.39	$ 0.31

CZAR RESOURCES LTD.
CONSOLIDATED STATEMENT OF DEFICIT
SIX MONTHS ENDED APRIL 30, 1986
(Unaudited)

	1986	1985 (restated)
Beginning of Period		
As previously stated	$(59,353,141)	$ 2,472,277
Retroactive change in accounting policy	—	$(64,937,164)
As restated	(59,353,141)	(62,464,887)
Net Earnings	3,382,814	2,888,041
End of Period	$(55,970,327)	$(59,576,846)

CZAR RESOURCES LTD.
CONSOLIDATED STATEMENT OF SOURCE AND USE OF CASH
SIX MONTHS ENDED APRIL 30, 1986
(Unaudited)

	1986	1985 (restated)
Operating Activities		
Net earnings	$ 3,382,814	$ 2,888,041
Depletion and depreciation	1,155,285	755,697
Working capital provided by operations	4,538,099	3,643,738
Net change in non-cash working capital items	(2,360,422)	(2,178,307)
Investing Activities		
Additions to fixed assets	(1,846,177)	(2,365,029)
Financing Activities		
Increase in bank loan	—	2,260,000
Issue of common shares	—	5,000
Discharge of limited partnership redemption obligations	(270,000)	(270,000)
Increase in cash	61,500	1,095,402
Cash at Beginning of Period	2,382,387	706,204
Cash at End of Period	$ 2,443,887	$ 1,801,606